

Islamic Banking and Finance Regulation in Malaysia: Between State Sharia, the Courts and the Islamic Moral Economy

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Abstract

This article examines Malaysia's emergence as a global centre of Islamic finance through a pragmatic centralised regulatory framework that promotes legal certainty and consonance with the conventional financial system rather than the development of a distinctly Islamic moral economy. It also highlights the judiciary's challenge to Central Bank regulatory dominance through civil *sharia* compliance cases based on Anglo-Muslim law.

Keywords: Islamic banking and finance; *sharia* compliance; Islamic moral economy; Malaysian Central Bank; Anglo-Muslim law; *bay bithaman ajil*; economic development; globalisation; *sharia* advisory council; *riba*; civil courts

Subject: Islamic banking and finance

Other subjects: Financial regulation; Economic development; *Sharia* compliance

Introduction

The Malaysian government has exerted tight regulatory control over the expansion of Islamic banking to ensure it serves as a cultural and political platform for Malaysia's inclusion in the global financial economy. The key legislative instruments - the *Islamic Banking Act* (1983), the *Central Bank of Malaysia Act* (2009) and the *Islamic Financial Services Act* (2013) - place the regulation of the *sharia* compliance of financial services under the authority of Central Bank technocrats. To create the legal certainty to attract global investments, the regulatory structure promotes Islamic finance products that closely imitate and compete with conventional products. Instruments such as the Islamic short sale have little substantive basis in Islamic

finance doctrine. Current Islamic finance practice in Malaysia departs from the vision of Islamic economists, developed in the 1970s, of a distinctly Islamic financial system based on Quranic principles of distributive justice, equity and social solidarity. In contrast to the debt-based, risk-transferring instruments of the conventional financial system, Islamic economists hoped the moral economy would offer particular benefit to developing countries by offering equity-based, risk-sharing finance and redistributive instruments to increase financial services access and promote just and equitable economic development. Despite the disjuncture between principles and practice, the government's strategy has been successful in solidifying a place for Malaysia in the global financial sector. Although input from Islamic economists, Islamic scholars and the judiciary is marginalised under the current regulatory framework, the Malaysian judiciary has incorporated Islamic financial principles into Anglo-Muslim law in civil *sharia* compliance cases, showing the potential to promote the evolution of Islamic finance in accordance with Islamic principles. These cases created tension between the Central Bank and the judiciary, which is likely to continue as key actors debate the economic or moral purpose of Islamic finance in Malaysia.

The Islamic Moral Economy

Since the 1970s, Islamic economists have sought to tie economic and financial activity to an Islamic ethical system¹. They aim to use Islamic principles to tame, but not undermine, the untrammelled acquisitive drive, greed and social inequality associated with Western economic development².

In contrast to Western models of economic development centred on the rational, individualistic maximisation of profit, Islamic economic development emphasises the core principles of the

¹ Tripp, C, *Islam and the Moral Economy: The Challenge of Capitalism*, Cambridge University Press, Cambridge, 2006

² Tripp, 2006

Quran, namely, distributive justice, social solidarity and equity³. These core principles seek to achieve a collective development that avoids excessive wealth and extreme poverty⁴. Applying this understanding to Islamic finance, the International Association of Islamic Banks specified that profitability is not the sole criterion for Islamic bank performance evaluation as they have social obligations to the community as a whole⁵. According to Islamic economists, the sum of individual economic transactions by socially-conscious rather than profit-driven actors, could form the basis for an Islamic moral economy⁶. Islamic finance is a key part of the Islamic moral economy.

Principles of Islamic Finance

Islamic finance refers to money management and capital provision in a manner that complies with Islamic rules for economic action⁷. Islamic economists derive five main organising principles from the Quran that serve as the foundation of the ideal Islamic just and equitable financial system⁸. These are: the prohibition of *riba*, risk-sharing, the prohibition of uncertainty, redistribution of wealth and ethical investment (Iqbal & Mirakhor, 2013). These principles distinguish Islamic economic activity from conventional economic activity.

The prohibition of *riba*, or the wide conventional practice of charging interest, is based on the Islamic idea of distributive justice⁹. It demands that wealth be acquired from fair contracts of exchange and true productive effort. Islamic economists contrast the operation of this principle with conventional debt-based contracts where one wealthy party is able to merely ‘make money

³ Iqbal, Z, and Mirakhor, A, *Economic Development and Islamic Finance*, The World Bank, Washington, 2013

⁴ Iqbal & Mirakhor, 2013

⁵ Tripp, 2006

⁶ Iqbal & Mirakhor, 2013

⁷ Wilson, R, *Legal, Regulatory and Governance Issues in Islamic Finance*, Edinburgh University Press Ltd, Edinburgh, 2012

⁸ Iqbal & Mirakhor, 2013

⁹ Ibid

from money' regardless of the outcome of entrepreneurial activity and without transferring property rights over the money loaned to the borrower¹⁰. To ensure distributive justice, Islamic financial instruments *share risk* among market participants rather than allowing it to transfer and concentrate in the borrowing class¹¹. The prohibition of debt and the endorsement of risk-sharing promotes a financial system based on trade and exchange in commodities and assets, where equity-based contracts exchange one bundle of real property rights for another¹².

In Islamic partnership contracts, such as *musharakah* and *mudarabah* the providers of financial capital and the entrepreneur share business risks in return for a specified percentage of prospective profits pre-determined in a profit and loss sharing agreement¹³. Under *musharakah* contracts, the bank and entrepreneur both provide capital and share management of the project. Under *mudarabah* contracts, the entrepreneur primarily risks the opportunity costs - including labour, expertise or time - while the bank bears all financial losses¹⁴. Deposits are also invested in the business of the financial institution under *mudarabah* contracts, with Islamic banks becoming entrepreneurs by investing deposits in the projects of the financial institution¹⁵. These contracts are consistent with the Quran because they ensure any profit will be the outcome of real productive activity and business failure will not result in unjust penalisation of the borrower¹⁶. Venture capital type arrangements also promote social solidarity as there is

¹⁰ Iqbal & Mirakhor, 2013: 117

¹¹ Iqbal & Mirakhor, 2013

¹² Askari, H, *Globalisation and Islamic Finance: Convergence, Prospects and Challenges*, John, Wiley & Sons, Singapore, 2010

¹³ Mansour, W, "How Ethical Is Islamic Banking in the Light of the Objectives of Islamic Law?", *Journal of Religious Ethics* (2015) 43(1): 51-77

¹⁴ Ibid

¹⁵ Aldohni, A, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative look at the United Kingdom and Malaysia*, Routledge, Oxford, 2011

¹⁶ Tripp, 2006

harmony between the interests and activities of entrepreneurs, depositors and financial institutions¹⁷.

To avoid conflict and exploitation resulting from informational asymmetries, Islamic contracts must also avoid uncertainty regarding the extent of the financial obligations of the parties¹⁸. This eliminates extreme speculative behaviour and non-disclosure from the Islamic financial system¹⁹. Contractual obligations must be precisely and clearly stated to avoid future ambiguity and variability, for example in the price or quality of goods exchanged²⁰.

Because Muslims hold property and wealth on trust for Allah, they are under an obligation to use it to promote collective well-being through *redistributive instruments* such as *zakat* (obligatory tax for social welfare), *sadaaah* (voluntary charity) and *qard-al-hassan* (benevolent loans)²¹. Under these instruments, the economically more able segment of society shares the risks facing the less able segment of the population²².

Islamic financial institutions must only make *ethical investments*. This prohibits investments in objects explicitly prohibited in the Quran, such as pork, alcohol and gambling. More restrictive versions of this principle discourage investment in sectors that are contrary to Islamic morality such as sexually explicit entertainment²³.

Islamic Finance and Economic Development

Islamic economists hold that risk-sharing instruments and redistributive instruments offer a comprehensive approach to equitable economic development by improving access, including

¹⁷ Aldhoni, 2011

¹⁸ Rudnycky, D, "From Wall Street to Halal Street: Malaysia and the Globalisation of Islamic Finance", *The Journal of Asian Studies* (2013) 72(4): 831-848

¹⁹ Iqbal&Mirakhor, 2013

²⁰ Rudnycky, 2013

²¹ Iqbal&Mirakhor, 2013

²² Ibid

²³ Ibid

potential entrepreneurs, to financial services²⁴. Whereas conventional finance favours established businesses that have collateral for credit, the non-debt venture capitalist model of Islamic banks favours productive investments in small and medium new enterprises as well as large-scale infrastructure projects that stimulate economic development²⁵. Finance without crippling interest or financial risk and a risk-sharing framework that fosters long-term goal setting and a willingness to weather misfortune allows new entrepreneurs to innovate and thrive²⁶.

Islamic finance can also address the failures of conventional financial inclusion mechanisms associated with high interest on micro-finance loans and inadequate funds for business skills investment²⁷. Islamic redistributive instruments, used in conjunction with interest-free, partnership-based micro-finance can provide the poor with the skills to become micro-entrepreneurs, diversify household income, mobilise savings for health and education and ultimately move out of poverty²⁸. Islamic finance can extend the benefits of savings accumulation to Muslims who are voluntarily or involuntarily excluded from the financial system due to religious, economic or social reasons²⁹.

After the financial crisis, Islamic finance experts argued that an equity-based financial system is more stable and supportive of sustainable financial development and growth³⁰. The link between Islamic bank deposits and real economy investments limits the risk of unbacked credit

²⁴ Iqbal&Mirakhor, 2013

²⁵ Warde, Ibrahim, "The Relevance of Contemporary Islamic Finance", *Berkley Journal of Middle Eastern & Islamic Law* (2009) 6(2) 159

²⁶ Ibid

²⁷ Iqbal&Mirakhor, 2013

²⁸ World Bank, *On the Sustainable Development Goals and the Role of Islamic Finance*, World Bank, Washington, 2015

²⁹ Ibid

³⁰ Warde, 2009

expansion associated with the conventional system³¹. Bank runs based on changes to deposit interest rates after a decline in bank returns is also impossible under the Islamic system as tangible assets cover Islamic bank liabilities³². Islamic economists view Islamic finance as a viable alternative to debt-based capitalism provided that Islamic bank liquidity management issues, associated with holding real assets in a depressed asset market, can be addressed³³.

Islamic economists put forth a grand vision of an Islamic ethical capitalism based on principles of distributive justice, profit and loss sharing, and equity-based financing³⁴. However, due to the predominance of the Malaysian government's alternative vision for Islamic finance, Islamic development economists have played only a small role in the practice of Islamic finance in Malaysia.

Malaysian Government Policy : Islamic Finance and Globalisation

The Malaysian government has promoted Islamic finance as part of its economic and political strategy since the 1970s³⁵. Seeking to co-opt Islamist political critiques regarding “western capitalist blueprints for modernity”³⁶, the government invoked Islamic finance to promote a form of Islam that was compatible with and supported the state's economic development objectives³⁷. Following ethnic riots in the late 1960s between wealthy Chinese and disgruntled Muslim Malays, the government took a special interest in the economic development of its Islamic citizens³⁸. To encourage entrepreneurship, savings mobilisation and capital accumulation among Muslim Malays, the government used Islamic finance as a platform to

³¹ World Bank, 2012

³² Warde, 2009

³³ Warde, 2009

³⁴ Iqbal&Mirakhor, 2013

³⁵ Khiyar, K, “Malaysia: 30 Years of Islamic Banking Experience (1983-2012)”, *International Business and Economics Research Journal* (2012) 11(10): 1133

³⁶ Rudnyckyj, 2013: 840

³⁷ Rudnyckyj, 2013

³⁸ Khiyar, 2012

persuade them that full-scale participation in a capitalist economy was permitted under Islamic rulings³⁹.

The Malaysian government is now leveraging Islamic practice in pursuit of economic development goals on a global rather than merely domestic scale⁴⁰. With the emergence of lower-wage sites for industrial assembly in China, Vietnam and Indonesia, and the rise of Malaysian incomes and education levels, the government departed from its export-oriented economic growth policy⁴¹. It is focused on isolating global market niches in providing services labelled Islamic, including halal certification services and Islamic financial services⁴². It aims to become a global hub for Islamic finance, mobilising religion to create new Islamic global financial networks⁴³. Anwar Ibrahim said when he was Finance Minister and Deputy Prime Minister, ‘Muslims must be able to compete in the banking sector as in other areas. They must respond to changes in the financial world’⁴⁴. Upon establishing the Malaysian Islamic financial system in 1983, the government’s goal was to promote rapid increases in the number of Islamic financial instruments and financial firms operating in the sector within a short fifteen year timetable⁴⁵. References to religious doctrine or values of distributive justice and equity were only mentioned in token form in policy documents⁴⁶.

The Malaysian government’s vision for Islamic finance departs significantly from the Islamic economist’s ideal of distinct Islamic financial institutions that specialise exclusively in risk-

³⁹ Rudnycky, D, “Islamic Finance and the Afterlives of Development in Malaysia”, *Political and Legal Anthropology Review* (2014) 37(1):69

⁴⁰ Ibid

⁴¹ Ibid

⁴² Ibid

⁴³ Rudnycky, 2013

⁴⁴ Khiyar, 2012: 1134

⁴⁵ Khiyar, 2012

⁴⁶ Maznah, M, “Islamic Banking and Finance: Sacred Alignment, Strategic Alliances”, *Pacific Affairs* (2015) 88(2): 194

sharing and redistributive instruments in support of just, equitable and cohesive economic development⁴⁷. While financial inclusion and economic development of Muslims is a goal of Malaysian Islamic financial institutions⁴⁸, the government aims primarily to create a culturally-based competitive niche within the existing debt-based, profit-driven system⁴⁹. As a result, rather than focusing on the development of distinctly Islamic financial principles and products⁵⁰, the government nurtured an Islamic financial legal and regulatory system that would support integration and competition with conventional finance⁵¹.

Malaysian Anglo-Muslim Law

In Malaysia, Islamic law operates within the English-inherited common law system of the Malaysian state⁵². The concepts of *sharia* and *fiqh* inform understandings of Islamic law⁵³. The *sharia* is immutable. It extends beyond traditional conceptions of the ‘law’ to encompass principles and values to guide the general Islamic way of life as prescribed by Allah⁵⁴. *Fiqh* is Islamic jurisprudence. It refers to the dynamic interpretation and application of Islamic principles to changing circumstances⁵⁵.

⁴⁷ Warde, 2009

⁴⁸ Khiyar, 2012

⁴⁹ Maznah, 2015

⁵⁰ Mansoori, M, “Is Islamic Banking Islamic? Analysis of Current Debate on Shari’ah Legitimacy of Islamic Banking and Finance”, *Islamic Studies* (2011) 50 (3/4): 383-411

⁵¹ Maznah, M, “Islamic Banking and Finance: Sacred Alignment, Strategic Alliances”, *Pacific Affairs* (2015) 88(2): 194

⁵² Moustafa, M, “Judging in God’s Name: State Power, Secularism, and the Politics of Islamic Law in Malaysia”, *Oxford Journal of Law and Religion* (2014) 3(1): 152-167

⁵³ Ibid

⁵⁴ Ibid

⁵⁵ Ibid

Sharia values and *fiqh* pose particular problems for the creation of a legal environment conducive to global financial investment⁵⁶. The predictability provided by state formally rational positivist law is indispensable to capitalist economic development⁵⁷. As the rules governing economic life are clear, consistent and universally-applied by a single legal authority, entrepreneurs can make long-term investments with the legal certainty that their rights and the obligations of others in business dealings would be enforced⁵⁸. In contrast, *sharia* values are vague and ill-defined religious concepts applied by a multitude of religious authorities with reference to a variety of sources⁵⁹. This has resulted in an unrestrained number of interpretations of *sharia* and considerable uncertainty⁶⁰. Hooker⁶¹ argues that *sharia* in Southeast Asia often fails to meet basic indicators of legal efficacy. For example, *sharia* does not extract general compliance from the population, *sharia* principles lack consistent and universal elements applicable to all factual circumstances and values cannot be effectively administered by state officials⁶².

To address issues of legal ambiguity, the Malaysian state and judiciary have attempted to monopolise and rationalise Malaysian *sharia* by selectively including fragments of *fiqh* in state positive law and common law judicial decisions that apply to Muslim citizens, creating an ‘Anglo-Muslim’ law⁶³. To ensure Malaysian Islamic financial institutions could serve as a predictable platform for international finance, the rationalisation of Islamic financial law

⁵⁶ Ahmed, H, “Islamic Law, Adaptability, and Financial Development”, *Islamic Economic Studies* (2006) 13(2)

⁵⁷ Trubek, David M ‘Toward A Social Theory Of Law: An Essay On The Study Of Law and Development’ (1972) 82 *The Yale Law Journal* 1,

⁵⁸ Ibid

⁵⁹ Hooker, M.B, *Indonesian Syariah: Defining a National School of Islamic Law*, ISEAS Publishing, Singapore, 2008

⁶⁰ Ibid

⁶¹ Ibid

⁶² Ibid

⁶³ Moustafa, 2014: 159

regarding *sharia* compliance became a key part of the government's Islamic banking and finance strategy⁶⁴. It situated *sharia*-based financial instruments under the conventional financial legal and regulatory framework tightly controlled by the state, allowing little room for the development of sharp distinctions between Islamic and conventional financial instruments⁶⁵.

Islamic Finance Regulation: A Dual System

Unlike Sudan, Pakistan and Iran, which sought to transform their entire financial system into an Islamic system, Malaysia developed Islamic finance in parallel with conventional banking⁶⁶. The dual system strategy suited Malaysia's multi-racial society⁶⁷. It also gave Malaysia a competitive advantage over unitary systems⁶⁸. It maintained order in the conventional system while allowing new Islamic banks to use existing conventional infrastructure and branches⁶⁹. It also extended the reach of Islamic financial services, with the Malaysian Central Bank able to offer tax-breaks to encourage conventional banks to open Islamic subsidiaries⁷⁰. In accordance with policy goals, the strategy disseminated Islamic banking throughout the country quickly and efficiently⁷¹. The number of Muslim Malays with access to financial services increased from 4% in 1970 to nearly 30% by 1990⁷². However, the overlap between the two systems provided the conditions for growth of Islamic finance based on imitation of conventional finance⁷³.

⁶⁴ Wilson, 2012

⁶⁵ Maznah, 2015

⁶⁶ Khiyar, 2012

⁶⁷ Aldhoni, 2011

⁶⁸ Khiyar, 2012

⁶⁹ Ibid

⁷⁰ Hooker, M.B, *Indonesian Syariah: Defining a National School of Islamic Law*, ISEAS Publishing, Singapore, 2008

⁷¹ Khiyar, 2012

⁷² Ibid

⁷³ Wilson, 2012

The Islamic Banking Act (1983)

The *Islamic Banking Act* of 1983 (the Act) established the Islamic financial system in Malaysia. Its distinctively Islamic features are limited⁷⁴. The licensing, management, ownership and financial requirements for Islamic banks are identical to that for conventional banks⁷⁵. All Islamic banks fall under the regulatory control of the Malaysian Central Bank⁷⁶. S2 of the Act defines Islamic banking business as those “whose aims and operations do not involve any element which is not approved by the religion of Islam”. The Act does not clearly articulate types of Islamic financial instruments or otherwise provide any *sharia*-based guidance regarding the application of this provision⁷⁷. It does not, for example, outline the principles of Islamic finance as defined by Islamic economists. It also fails to specify which source and court of law applies in the case of a dispute regarding the piety of Islamic banking business⁷⁸. The ambiguity of this provision implicitly allows Islamic banks to offer banking services similar to conventional finance services, provided they have religious approval⁷⁹.

Sharia Advisory Councils

Under the Act, ‘religious approval’ is in the first instance to be given by the Islamic bank’s dedicated *Sharia* Advisory Council. The *Sharia* Advisory Council (SAC) is a body of Islamic scholars who have the authority to interpret Islamic sources and certify that financial products are *sharia*-compliant⁸⁰. There are issues regarding the transparency, consistency and independence of SAC decision-making as they are ultimately remunerated and appointed by

⁷⁴ Aldhoni, 2011

⁷⁵ Ibid

⁷⁶ Ibid

⁷⁷ Ibid

⁷⁸ Ibid

⁷⁹ Maznah, 2015

⁸⁰ Askari, H, *Globalisation and Islamic Finance: Convergence, Prospects and Challenges*, John, Wiley & Sons, Singapore, 2010

the banks they serve⁸¹. There is also little doctrinal guidance for SACs adjudicating *sharia* compliance⁸². Most guidelines are concerned with Islamic ethical investments rather than issues of distributive justice such as risk-sharing and the *riba* prohibition⁸³. Due to the position of SACs within banks and the absence of comprehensive *sharia* compliance guidelines, many believe SACs merely sanction the modification of conventional debt-based finance instruments as *sharia* complaint, without demanding any substantive adherence to Islamic principles such as risk sharing⁸⁴. Others express concern regarding the possibility for inconsistent decisions among different SACs, resulting in a decline in consumer confidence in Islamic finance products⁸⁵. Given the lack of transparency of SAC decisions it is difficult to determine the extent to which they are a source of legitimization of practice or of legal ambiguity. However, the proliferation of controversial debt-based instruments and subsequent increase in *sharia* compliance litigation in the courts from 2002, discussed below, indicates that SACs are not issuing effective, consistent or authoritative *sharia* compliance decisions.

The Central Bank of Malaysia Act (2009): The National Sharia Advisory Council

To rationalise and prevent conflicting interpretations of *sharia* compliance by SACs and the courts, the Malaysian Central Bank formed the National *Sharia* Advisory Council (NSAC) in 1997⁸⁶. NSAC is the sole authority advising the Central Bank on *sharia* issues in Malaysia⁸⁷. The NSAC is comprised of prominent *sharia* scholars, jurists and finance professionals. S29 of the 2009 *Central Bank of Malaysia Act* (the *Central Bank Act*) made NSAC the sole and final authoritative body on *sharia* matters pertaining to Islamic finance. Its rulings prevail over that of SACs. Under s56, the courts are required to take into consideration *or* refer matters for

⁸¹ Askari, 2010

⁸² Iqbal&Mirakhor, 2013

⁸³ Aldhoni, 2011

⁸⁴ Khan, 2010

⁸⁵ Aldohni, 2011

⁸⁶ Rudnyckyj, 2013

⁸⁷ Aldohni, 2011

NSAC rulings when presiding over Islamic finance disputes. If rulings are asked for, they are binding on the courts. As NSAC is situated under the Central Bank regulatory framework, the *Central Bank Act* essentially placed the doctrinal and legal development of Islamic banking and finance under the control of state technocrats⁸⁸. In 2008, before NSAC's role was strengthened, the judiciary refused in *Arab Malaysian Merchant Bank Bhd v Silver Concept*⁸⁹ to refer to NSAC rulings because it was a 'part of the executive branch of government'. However, in *Tan Sri Abdul Khalid Ibrahim v Bank Islam Malaysia Berhad*⁹⁰ the court ruled that the *Central Bank Act* was not unconstitutional. The *Islamic Financial Services Act* (2013) further enhanced the power of the Central Bank, allowing them to use Alternative Dispute Resolution mechanisms instead of the courts to resolve Islamic finance disputes.

In an attempt to reduce legal ambiguity surrounding *sharia* compliance, the regulatory framework for Islamic banking and finance de-emphasises substantive doctrinal issues and marginalises the impact of traditional religious scholars, the judiciary and Islamic economists in favour of globalising financial technocrats and practitioners⁹¹. Finance practitioners are former conventional bankers who lack moral and religious understanding of the difference between debt-based and equity-based contracts⁹². They draw on their knowledge of conventional financial instruments to develop Islamic financial instruments, making only minor modification to ensure *sharia* compliance.

The Islamic Short Sale

⁸⁸ Maznah, 2015

⁸⁹ *Sdn Bhd [2008] 6 MLJ 299*

⁹⁰ (2012) 1 LNS 634

⁹¹ Maznah, 2015

⁹² Rudnycky, 2013

Instead of the equity-based *mudarabah* and *musharakah* contracts, over 90% of contracts in Malaysian commercial banks are sales-based mark-up transactions for short term financing⁹³. One of the most common sales contracts, *murabahah*, was developed to provide more predictable profits for depositors and borrowers who were concerned about the notion of fluctuating project returns that could become a loss⁹⁴. Under *murabahah*, the bank buys commodities on behalf of a client and adds a sum to the price charged⁹⁵. The client assumes ownership of the goods and agrees to pay the sum back at a specified future date⁹⁶. Many authorities argue *murabahah* is *sharia* compliant because it involves an agreement based on a real transaction and the mark up is not a function of the time taken to repay the bank⁹⁷. Others hold it is not risk-sharing in any meaningful sense⁹⁸. The Islamic short sale has no real underlying material transaction or joint productive purpose⁹⁹. Furthermore, they imitate conventional collateralised debt contracts or loans, using current market interest rates as pricing benchmarks¹⁰⁰.

Many banks have enhanced the concept of *murabahah* to provide cash finance for clients through the *tawarruq*¹⁰¹. Under a *tawarruq* the bank buys the goods and offers it to the client with a mark-up that it agrees to pay in future instalments¹⁰². At the same time, the bank offers to re-sell the good for the client on the international market for the same price the bank

⁹³ Mansour, W, “How Ethical Is Islamic Banking in the Light of the Objectives of Islamic Law?”, *Journal of Religious Ethics* (2015) 43(1): 51-77

⁹⁴ Tripp, 2006

⁹⁵ Warde, 2009

⁹⁶ Ibid

⁹⁷ Markom, R, “Adjudication of Islamic banking and finance cases in the civil courts of Malaysia”, *European Journal of Law and Economics* (2013) 36: 1-34

⁹⁸ Khan, 2010

⁹⁹ Ibid

¹⁰⁰ Ibid

¹⁰¹ Robbins, H, “Soul-searching and Profit Seeking: Reconciling the Competing Goals of Islamic Finance”, *Texas Law Review* (2010) 88(5): 1125

¹⁰² Ibid

originally paid for it¹⁰³. This is very similar to a conventional loan with the client making deferred payments in return for a cash advance¹⁰⁴. It also mimics conventional methods that allow the selling and trading of debt. As with the *murabahah*, the *tawarruq* has no substantive material, partnership or productive value, obfuscating the socio-economic benefits of Islamic finance¹⁰⁵.

A Gateway to Globalisation

The ideal of a distinctly Islamic moral economy has not materialised in Malaysia¹⁰⁶. Islamic banks deal mainly in short-term debt-based, conventional style contracts for the consumer market, failing to promote the large-scale projects, micro-finance mechanisms, financial stability and redistributive instruments envisaged by Islamic economists as the basis of just and equitable development¹⁰⁷.

Nevertheless, the government's Islamic finance strategy has been successful, with Malaysia solidifying a place in the global financial economy¹⁰⁸. In 2011, the Malaysian Islamic financial sector grew faster than any other sector in the global banking industry, with an average growth rate of 20% between 2006 and 2011¹⁰⁹. Malaysia has 17 Islamic banks, including units in HSBC holdings, OCBC and Standard Chartered PLC¹¹⁰. Foreign financial institutions make Malaysia their destination of choice to conduct Islamic banking.

Islamic finance also increased the involvement of Muslim Malays in the development process by improving their access to finance and levels of savings and investment¹¹¹. The risk-sharing

¹⁰³ Ibid

¹⁰⁴ Khan, 2010

¹⁰⁵ Ibid

¹⁰⁶ Warde, 2009

¹⁰⁷ Iqbal&Mirakhor, 2013

¹⁰⁸ Khiyer, 2012

¹⁰⁹ Ibid

¹¹⁰ Ibid

¹¹¹ Ibid

ethos has not disappeared entirely, with many Islamic banks showing forbearance to distressed borrowers by extending benevolent loans to help clients¹¹².

The Future of Islamic Finance: The Role of the Courts

The Malaysian constitution provides the civil courts, not religious courts, with the jurisdiction to hear all cases pertaining to financial and commercial matters, including those that involve Muslims¹¹³. This is prudent because many financial cases also involve non-Muslims. Islamic *sharia* compliance cases in the civil courts are mainly concerned with the *bay bithaman ajil* (BBA). The BBA is an Islamic deferred payment sale contract used widely in Malaysia to purchase properties or assets. The bank buys a property and sells it to the client for a mark-up, with the bank retaining the right to sell the property if the client defaults¹¹⁴. It differs from a *murabahah* because it allows for a deferred delivery or payment and does not require disclosure of a specific profit margin up front.

Without considering the issue of *sharia* compliance, the court in *MBB v Marilyn Ho Siok Lin*¹¹⁵ and *Malayan Banking Bhd. V Ya'kup Oje & Anor*¹¹⁶, held that it was contrary to Quranic principles of justice and equity to demand the full marked up sale price from the defaulting party under the BBA as excessive profit is not permissible.

In *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors*¹¹⁷ the High Court, looking at the underlying substance or purpose of the terms of the transaction and applying common law principles of equity, held the BBA was a not a bona fide sale. In substance, it was

¹¹² Warde, 2009

¹¹³ Markom, R, "Adjudication of Islamic banking and finance cases in the civil courts of Malaysia", *European Journal of Law and Economics* (2013) 36: 1-34

¹¹⁴ Ibid

¹¹⁵ [2006] 7 MLJ 249

¹¹⁶ [2007] 6 MLJ 389

¹¹⁷ [2008] 5 MLJ 631

a financing transaction and the profit portion arising from BBA sales was in fact interest and therefore contrary to the *Islamic Banking Act* of 1983. The prospect of the courts enforcing the prohibition against *riba* prompted the reforms strengthening the role of the NSAC¹¹⁸. The Appeals Court overturned the High Court decision.

In *Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and other appeal*¹¹⁹ the Appeals Court held any comparison between a BBA sales contract and a conventional loan agreement for money lending was not appropriate. Consideration of whether bank business is in accordance with Islam requires reference to NSAC resolutions. This was recently confirmed in *Bank Kerjasama Rakyat Malaysia Bhd v Brampton Holdings Sdn Bhd*¹²⁰.

Although the current position of the Malaysian judiciary is to focus on the procedural requirements for *sharia* compliance, the courts have showed the ability to rationally incorporate principles of Islamic finance into Anglo-Muslim law and achieve a result that is closer to the just and equitable vision of Islamic economists¹²¹. Given the dominant role played by the courts in *sharia* rationalisation and selection in Malaysia¹²², the courts have the potential to strike a workable balance between legal certainty and the Islamic finance principles on risk-sharing and *riba* prohibition.

Conclusion

As a result of the regulatory dominance of technocrats, Islamic finance practice in Malaysia focuses on ensuring that the form, not the substance, of contracts are *sharia* compliant¹²³. It emphasises legal certainty, as well as imitation and competitiveness with the debt-based

¹¹⁸ Maznah, 2015

¹¹⁹ [2009] 6 MLJ 839

¹²⁰ [2015] 4 CLJ 635

¹²¹ Markon, 2013

¹²² Moustafa, M, "Judging in God's Name: State Power, Secularism, and the Politics of Islamic Law in Malaysia", *Oxford Journal of Law and Religion* (2014) 3(1): 152-167

¹²³ Maznah, 2015

services of the global financial system¹²⁴ rather than fair, innovative and equitable development motivated by Quranic principles of social solidarity, distributive justice and equity. Consequently, there is little real difference in practice between Islamic and conventional banking instruments.

Although the foundation has not been set for the just and equitable capitalist development envisaged by Islamic economists, the emergence of banking institutions that are politically or culturally identified as uniquely Islamic has allowed Malaysia to benefit from globalisation. The economic development value of Islamic financial instruments and services as opposed to conventional finance for Malaysia is the cultural brand and market it creates within the existing global economy¹²⁵.

The judiciary have shown a willingness to promote a more constructive balance between the government's pragmatic globalising agenda for Islamic finance and the principles of the Islamic moral economy. Whilst this has not weakened state control over Islamic finance, the relationship between the Central Bank and the courts is likely to be one of tension as debates continue regarding the purpose and substantive content of Islamic finance regulation in Malaysia.

¹²⁴ Maznah, 2015

¹²⁵ Rudnycky, 2014